

WATTER'S ABOUT TO RUN DRY FOR NATIONAL BANKS USING OPERATING SUBSIDIARIES TO CIRCUMVENT PROGRESSIVE STATE CONSUMER PROTECTION LAWS

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I. INTRODUCTION

In the wake of the “Great Recession,” the Obama administration seemed poised for a complete overhaul of the financial service regulatory environment. As part of that plan, the administration proposed the creation of a new agency, the Consumer Financial Protection Agency¹ that would be armed with regulatory powers to fight for consumer protection. The proposed agency has been heralded as the tool the government needs to fight against Wall Street for the people of Main Street, with many proclaiming that no longer will big banks operate under rules that they created.² Alternatively, critics of the agency have damned the proposal as creating an independent credit czar that will stifle innovation resulting in increased costs for consumers. Coming as no surprise, considering the current partisanship of our government, the lines were drawn largely on party lines.³ Democrats generally supported the idea and Republicans generally opposed the plan.⁴

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¹ Hereinafter CFPB.

² Press Release, House Speaker Nancy Pelosi, Today's Action by Financial Services Committee Brings Accountability to Wall Street and Big Banks (Dec. 2, 2009), *available at* <http://www.speaker.gov/newsroom/pressreleases?id=1459> (“Today's action by the House Financial Services Committee brings accountability to Wall Street and big banks. When coupled with strong reforms to protect consumers and Main Street... it will end the reckless practices that resulted in the worst financial crisis since the Great Depression.”).

³ H.R. 4173, 111th Cong. (2009) [hereinafter H.R. 4173 Open Congress]; *see also* OpenCongress, http://www.opencongress.org/bill/111-h4173/actions_votes (on December 11, 2009, the United States House of Representatives passed H.R. 4173, legislation proposed to create the CFPB with 223 in favor of the bill, 202 against the bill and 9 abstaining from the vote. No Republicans voted in favor of the bill).

⁴ *Id.* *See also* Press Release, GOP, Democrats Financial Reforms Show Contempt for Capitalism and Continue to Destroy Jobs (Nov. 23, 2009), *available at*

However, those traditional lines seem blurred when one takes a closer look at the legislation and how it treats the issue of federal preemption for subsidiaries of nationally chartered banks. After the decision in *Watters v. Wachovia Bank*, Federal regulations preempt state regulations for operating subsidiaries of nationally chartered banks, even though “the operating subsidiaries” may be state chartered.⁵ The Bills that propose to create the Consumer Financial Protection Agency, however, purport to overturn that decision by clarifying that subsidiaries will be subject to state law the same as any other state entity. Ostensibly, it seems that this reversal of federal preemption is a compromise between supporters of the bill; Democrats who traditionally favor federal action- and Republicans, who traditionally favor a smaller federal government and stronger state governments. Could it be a bipartisan compromise from a partisan government?

This note will take a critical look at this proposition. By looking at the dual banking system through the lens of consumer protection laws, this Note proposes that Federalist principles have little to do with legislation purporting to overturn *Watters v. Wachovia Bank*. Rather, I argue that the real purpose behind such action is to subject banks to state regulation that is more progressive in the area of consumer protection. I will not address whether or not increased regulation over banks for consumer protection is in the best interest of the consumer, *i.e.* does it just decrease available credit and increase costs that the consumer will pay for later? Rather, I will attempt to describe what benefits and costs federally chartered banks will have in the future if they continue to operate through an operating subsidiary instead of fully integrating operations into their company.

Part II of this Note describes the administration’s proposal to create the Consumer Financial Protection Agency. I will first outline the agency generally, and then I will describe the various reactions to the proposal to illustrate how traditional partisan interests are blurred by the operational effects of the proposal. Finally, I will describe the particular provision in H.R. 4173 that overturns the decision of *Watters v. Wachovia Bank*.

Part III of this Note describes the *Watters v. Wachovia Bank* decision as well as the reactions to it and the interests implicated. First, I will take a close look at the decision itself from the Court’s perspective on the legal questions involved. Then I will describe the various interested parties. Through this lens, it will become apparent that the decision, like the provision in H.R. 4173, cuts across traditionally similar interests.

Part IV of the Note looks into the dual banking system and how predatory lending laws have developed. I will first describe the dual

<http://www.gop.gov/policy-news/09/11/23/democrats-financial-reforms-show-contempt>.

⁵ *Watters v. Wachovia Bank*, 550 U.S. 1 (2007).

banking system, generally, to gain some perspective on the pro-competitive reasons why people may support banks being able to choose who regulates them. Then I will look into the predatory lending problem and what laws are employed in an effort to protect consumers. Third, I will look into what federal predatory lending laws are currently in effect and how they are operating. Finally, I will look into state predatory lending laws through the lens of North Carolina and Massachusetts. While these states are considered to be very active in the predatory lending legal environment, I choose to look into them because they are indicative of the general trend toward progressive reform in the area of predatory lending.

Part V of the Note will compare federal and state predatory lending laws. Although not exhaustive, the examples I use indicate a larger trend toward federal laws being more concerned about creating a competitive banking environment and state laws being more concerned with protecting consumers.

Part VI of the Note looks into the motivations for nationally chartered banks to operate through a subsidiary and how the federal versus state predatory lending laws comparison may play a role in that. I argue that it does play a role, and therefore, legislation purporting to overturn *Watters v. Wachovia Bank* will have an effect on the number of banks that are federally chartered and the ease by which smaller banks will be able to compete with the smaller number of federally-regulated banks.

Finally, Part VII of the Note looks into the effects of the proposed legislation on the structure of banking operations and financial markets. While a significant trend is unlikely, the decision banks make about their operating subsidiaries will be indicative of the true cost of increased consumer protection legislation.

II. THE CONSUMER FINANCIAL PROTECTION AGENCY

In response to what many people believe to be the worst financial crisis since The Great Depression, the Obama Administration proposed changes to the financial service regulatory arena in the form of a ninety-page document called the President's "White Paper."⁶ The White Paper laid the foundation from which the administration would seek to accomplish five objectives: (1) promote robust supervision of financial firms; (2) establish comprehensive supervision of financial markets; (3) protect

⁶ U.S. DEP'T OF THE TREASURY, NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 3-4 (2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf [hereinafter White Paper].

consumers and investors from financial abuse; (4) provide the government with the tools it needs to manage financial crises; and (5) raise international regulatory standards.⁷

A. Generally

On June 30, 2009, the Obama administration made its first legislative proposal seeking to implement these objectives by introducing the Consumer Financial Protection Act of 2009.⁸ The Act proposed a new independent executive agency charged with the responsibility of enforcing most of the consumer protection laws.⁹ The Act gives the agency the authority over a vast array of financial activities including mortgages, deposit taking, credit cards, collection of consumer report data, debt collection, real estate settlements, and others.¹⁰ Under this Act, the CFPA would not have authority over insurance activities other than mortgages, title and credit insurance; however, as seen from how the act defines “covered person,” the range of entities engaged in financial activities that would be subjected to oversight of the CFPA is very expansive.¹¹ Similarly, the Act gives the CFPA wide latitude in determining what constitutes a “consumer product.”¹² Once something is characterized by the agency as a consumer product, the CFPA would be able to prohibit unfair rules

⁷ *Id.* See also Binyamin Applebaum & David Cho, *Obama Blueprint Deepens Federal Role in Markets*, WASH. POST, June 17, 2009, <http://www.washingtonpost.com/wp-dyn/content/article/2009/06/16/AR2009061601887.html>.

⁸ Consumer Financial Protection Agency Act of 2009, H.R. 3126, 111th Cong. (2009), available at <http://www.financialstability.gov/docs/CFPA-Act.pdf>.

⁹ David S. Evans & Joshua Wright, *How the Consumer Financial Protection Agency Act of 2009 would Change the Law and Regulation of Consumer Financial Products*, 2 BLOOMBERG L. REP. NO.10 (2009) (citing CFPA Act § 1011(a)) (“There is established the Consumer Financial Protection Agency as an independent agency in the executive branch to regulate the provision of consumer financial products or services under this title, the enumerated consumer laws, and the authorities transferred under subtitles F and H.”).

¹⁰ DAVID H. CARPENTER & MARK JICKLING, CRS REPORT FOR CONGRESS: FINANCIAL REGULATORY REFORM: ANALYSIS OF THE CFPA (2009), http://assets.opencrs.com/rpts/R40696_20090717.pdf.

¹¹ H.R. 3126, § 1001(9) (“any person who engages directly or indirectly in a financial activity, in connection with the provision of a consumer financial product or service [used primarily for personal, family, or household purposes]; or any [one who] provides a material service to, or processes a transaction on behalf of, [such] a person.”).

¹² CARPENTER & JICKLING, *supra* note 10, at 2 (citing William Kovaic, *The Consumer Financial Protection Agency and the Hazards of Regulatory Restructuring*, LOMBARD ST., Sept. 14, 2009, at 19, 25-26).

regarding that product, prescribe rules requiring disclosures of the costs, benefits, and risks for that product, and other actions.¹³

Under the Act, the CFPA will have a range of powerful rule making abilities, as the CFPA would be given the authority to promulgate rules and issue guidance in order to meet the objectives of the act.¹⁴ The only limitations on the rule making power of the agency comes from the various requirements of their justification for action.¹⁵ Perhaps the most controversial¹⁶ power the CFPA would have is the ability to define a "standard consumer product" and require consumers to opt out of the standard product before being offered alternative products.¹⁷

B. Responses to the CFPA

In response to the administration's proposal of the CFPA, Financial Service Committee Chairman Barney Frank introduced H.R. 3126, which largely mirrors the CFPA Act, on July 8, 2009.¹⁸ Then, on December 2, 2009, Congressman Frank introduced a new bill, H.R. 4173, The Wall Street Reform and Consumer Financial Protection Act of 2009, which authorizes the creation of the CFPA.¹⁹ Both resolutions mirrored the administration's proposal, although many provisions, including the plain

¹³ CARPENTER & JICKLING, *supra* note 10, at 2.

¹⁴ CFPA Act, *supra* note 8, § 1021(a) (the objective of the CFPA would be "to promote transparency, simplicity, fairness, and accountability for consumer financial products and services other than those regulated by the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC)").

¹⁵ For example, CFPA Act §1031 (b) requires that for rule making: "The Agency may prescribe rules identifying as unlawful unfair, deceptive, or abusive acts or practices in connection with any transaction with a consumer for a consumer financial product or service." CFPA Act, *supra* note 8, §1031(b).

¹⁶ See generally Peter Wallison *Unfree to Choose: The Administration's Consumer Financial Protection Agency*, AEI FIN. SERV. OUTLOOK, July 9, 2009, <http://www.aei.org/outlook/100056>. "The real trouble begins, however, when the administration's plan gets beyond the relatively simple issue of disclosure and proposes that the CFPA define standards for what the white paper calls "plain vanilla" products and services. The draft legislation describes them as "standard consumer financial products or services" that will be both "transparent" and "lower risk." According to the white paper, the CFPA will have authority "to require all providers and intermediaries to offer these products prominently, alongside whatever other lawful products they choose to offer." (citing CFPA Act §1031(b)(1)).

¹⁷ CARPENTER & JICKLING, *supra* note 10, at 2 (citing CFPA Act §1031(b)(1)).

¹⁸ H.R. 3126.

¹⁹ H.R. 4173.

vanilla formula,²⁰ were dropped.²¹ On December 11, 2009, the United States House of Representatives passed H.R. 4173 with 223 in favor of the bill, 202 against the bill and 9 abstaining from the vote.²² The vote received no bipartisan support, as no Republicans voted for the bill.²³

In the opinion of congressional Republicans, the new agency would be created in "contempt of capitalism," as it would stifle innovation, and would continue to destroy jobs.²⁴ Additionally, major special interests such as the American Bankers Association, the National Association of Federal Credit Unions, the U.S. Chamber of Commerce and the Mortgage Bankers Association among others publicly opposed the bill.²⁵

Democrats, however, characterized the bill as a triumph of democracy, and a signal of the government willing to fight Wall Street to

²⁰ The Obama administration uses this term to describe products that are simpler and have straightforward pricing. See White Paper, *supra* note 6, at 2.

²¹ MICH. BANKERS ASS'N, LEGISLATION SYNOPSIS: H.R. 4173 THE WALL STREET REFORM AND CONSUMER PROTECTION ACT (2009), available at <http://www.mibankers.com/downloads/Resources/SynopsisHR4173.pdf>.

²² OpenCongress, *supra* note 3.

²³ *Id.* See also Posting of Anjai Desai to Alston Bird Financial Market Crisis Blog, <http://www.alston.com/financialmarketscrisisblog/?entry=2697> (Oct. 16, 2009, 15:17 EST) ("Republican opposition to the bill articulated that the proposed agency would have "excessive, unprecedented regulation" and it would result in the restriction of credit and product innovation and consumer protection"); "Democrats summarized the Consumer Financial Protection agency as: "a new, independent federal agency solely devoted to protecting Americans from unfair and abusive financial products and services." *Id.*

²⁴ GOP, *supra* note 4. "This proposal would establish an independent agency in the executive branch to regulate financial products and services. An unelected "credit czar" would be able to dictate what financial products could be offered and at what terms, drastically reducing the number of financial products available and driving up the cost of credit."

²⁵ OpenCongress, <http://www.opencongress.org/bill/111-h4173/money>; see also Press Release, Edward Yingling, ABA Statement on House Passage of Financial Regulatory Reform Bill (Dec. 11, 2009), available at <http://www.aba.com/Press+Room/121109ReformBillHR4173.htm>; Letter from John A. Courson on behalf of the Mortgage Bankers Association to House Speaker Pelosi (Dec. 9, 2009), available at www.mbaa.org/files/ResourceCenter/MIRA/LetterOpposingHR4173.pdf; Letter from R. Bruce Joston to the Members of the U.S. House of Representatives (Dec. 10, 2001), http://www.uschamber.com/issues/letters/2009/091210_hr4173.htm; Nat'l Ass'n of Fed. Credit Unions, *News: House Clears H.R. 4173 223-302*, Dec. 11, 2009, <http://www.nafcu.org/Template.cfm?Section=News&template=/contentManagement/contentDisplay.cfm&contentID=44758>; see also GOP, *supra* note 4 (noting that in addition to these agencies, twenty-one other industry trade associations are opposed to this bill).

protect the consumers on Main Street.²⁶ Similarly, scholars like Elizabeth Warren²⁷ maintain that the agency will arm the government with the tools they need to combat the abusive practices of Wall Street to promote the well-being of the middle class.²⁸ Other scholars argue that the current regulatory environment places a higher value on protecting the interests of the consumer *vendors* instead of protecting the *consumers*, and this new agency is an appropriate response to the situation.²⁹

While the debate over the new agency certainly cuts across traditional debates about the precise role of government in their regulation of the marketplace in order to protect consumers, a more practical approach may be to analyze the role that this new agency will have in light of the current shortcomings of consumer protection regulation.³⁰ For example,

²⁶ Press Release, House Speaker Nancy Pelosi, Pelosi: 'Today's Action by Financial Services Committee Brings Accountability to Wall Street and Big Banks' (Dec. 12, 2009), *available at*

<http://www.speaker.gov/newsroom/pressreleases?id=1459>. "Today's action by the House Financial Services Committee brings accountability to Wall Street and big banks. When coupled with strong reforms to protect consumers and Main Street...it will end the reckless practices that resulted in the worst financial crisis since the Great Depression." *Id.*

²⁷ Elizabeth Warren is the Leo Gotlieb Professor of Law at Harvard Law School and the Chair of the Congressional Oversight Committee. *See* Congressional Oversight Panel, <http://cop.senate.gov/about/bio-warren.cfm> (last visited Mar. 25, 2010).

²⁸ Shahien Nasiripour, *Will The Banks Win Again? Bailout Watchdog Rallies Support for Consumer Protection Agency: Elizabeth Warren Letter*, HUFFINGTON POST.COM, Jan. 19, 2010, http://www.huffingtonpost.com/2010/01/19/will-the-banks-win-again_n_427652.html ("The fate of the Consumer Financial Protection Agency will be the best way to follow the story moving forward because consumer products were the most abusive and because the CFPA has real muscle to stop those abuses. The CFPA would hire new cops and change the way big banks do business . . . The next few weeks will determine whether families will have to play by rules written by the banks and for the banks – rules that let the industry get away with anything. In my view, we cannot let families lose again.").

²⁹ Letter from Professors of Consumer Law and Banking Law to Senators Dodd and Shelby and Representatives Frank and Baucus, (Sept. 29, 2009), *available at* <http://law.hofstra.edu/pdf/Media/consumer-law%209-28-09.pdf>.

³⁰ *See* Sharon Tennyson, *Analyzing the Role for a Consumer Financial Protection Agency* (Networks Fin. Inst. Policy Brief, Dec. 2009), *available at* papers.ssrn.com/sol3/papers.cfm?abstract_id=1525603 ("In the debate, much attention has been given to discussion of whether consumers are irrational and need paternalistic regulators to look after them, and whether inadequate consumer protection regulation was a contributor to the financial crisis. While politically engaging, these arguments risk distracting attention from two important principles

political debates center around the rationality of the consumer to argue for more regulation to protect these people.³¹ On the one hand, there should be less regulation to encourage these actors to become more rationale.³² On the other, regulations over consumer protection are warranted regardless of the rationality of the consumers. Therefore, the debate over the new agency should be more about specifics and less about generalities.³³

C. Operating Subsidiaries of National Banks and H.R. 3126, 4173

In response to many officials, including Congressman Frank, arguing that preemption of state laws hurts the ability of states to protect consumers³⁴, proposed H.R. 3126 amends the National Bank Act³⁵ and Home Owners Loan Act³⁶ to make non-depository institution subsidiaries, or affiliates of federally chartered banks, subject to state consumer financial laws.³⁷ It is not as clear whether this will also apply to subsidiaries of [federally chartered thrifts, as the preemption provision applicable to federally chartered thrift discourages state preemption by including the language of “and consistent with Federal law for those entities.”]³⁸ In making these changes, the proposed legislation renders the 2007 Supreme Court decision in *Watters v. Wachovia Bank*,³⁹ upholding the OCC’s⁴⁰

that should be at the heart of the discussion. First, consumer protection regulation is provided by all financial regulators and is warranted irrespective of the rationality of consumers or the immediacy of financial crises. Second, the need to modernize U.S. financial services regulation is clear and regulatory reorganization is an important part of that agenda.”).

³¹ See GOP, *supra* note 4 (arguing that regulation is not the answer to the problem because the costs will shift to consumers making the lending process more burdensome on them).

³² See Laurie A. Burlingame, *A Pro-Consumer Approach to Predatory Lending: Enhanced Protection Through Federal Legislation and New Approaches to Education*, 60 CONSUMER FIN. L.Q. REP. 460 (2006) (arguing that in addition to federal regulation, novel educational reforms are needed to offer meaningful protection for the majority of mortgage loans.).

³³ See Tennyson, *supra* note 30.

³⁴ Posting of David L. Beam to Global Financial Market Watch Blog, <http://globalfinancialmarketwatch.com> (Dec. 16, 2009).

³⁵ 12 U.S.C. § 38 (2006).

³⁶ 12 U.S.C. § 1461 (2006) [hereinafter referred to as HOLA].

³⁷ H.R. 3126, § 145-148 (“no provision of this title shall be construed as annulling, altering or affecting the applicability of State law to any non-depository institution, subsidiary, other affiliate, or agent of a national bank”). See also Broox W. Peterson, *The Consumer Financial Protection Agency: Different Ship, Same Chairs?*, 11 BANKING & FIN. SERVICES POL’Y REP. 1, 9 (2009).

³⁸ See Peterson, *supra* note 37, at 9 (concluding that “it is not clear what the status of subsidiaries and affiliates of federally chartered thrifts will be, given the added language described above.”).

³⁹ *Watters*, 550 U.S. at 1.

preemption of state consumer protection laws regulating operating subsidiaries of national banks who were themselves state chartered,⁴¹ obsolete.⁴²

H.R. 4173 slightly alters the provision, clarifying state law preemption standards for subsidiaries by only amending HOLA, not the National Bank Act.⁴³ Because the *Watters* decision was based on a lack of direction from HOLA, many commentators expect that given the express language of the statute, the legislation will eliminate preemption for operating subsidiaries of national banks and federal thrifts.⁴⁴

For those who favor the bill, H.R. 4173 § 4407(a) will have the effect of enhancing the effort of state and local governments trying to crack down on things such as predatory lending, moving the OCC out of their way.⁴⁵ Others favor H.R. 4173 § 4407(a) for doctrinal reasons, like federalism, for example. Here, a Federalist would favor the provision to correct the wrongdoings of the Supreme Court in their overlooking the

⁴⁰ The Office of Comptroller of the Currency (OCC) is the primary federal regulator for nationally chartered banks.

⁴¹ *Watters*, 550 U.S. at 1. See WookBai Kim, *Challenging the Roots of Subprime Mortgage Crisis: The OCC's Operating Subsidiaries Regulations and Watters v. Wachovia Bank*, 21 LOY. CONSUMER L. REV. 278, 280 (2009).

⁴² See Peterson, *supra* note 37, at 9.

⁴³ Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. § 4407(a) (2d Sess. 2009) ("IN GENERAL—The Home Owners' Loan Act (12 U.S.C. 1461 et seq.) is amended by inserting after section the following new section: 'SEC. 6. STATE LAW PREEMPTION STANDARDS FOR FEDERAL SAVINGS ASSOCIATIONS CLARIFIED'.")

⁴⁴ See Beam, *supra* note 34; Timothy R. McTaggart & Travis P. Nelson, *House Passes Major Financial Services Reform Package*, PEPPER HAMILTON LLP PUBLICATIONS, Dec. 29, 2009, http://www.pepperlaw.com/publications_update.aspx?ArticleKey=1673 ("the language purports to overturn *Watters*, which allowed preemption to extend to operating subsidiaries of national banks.").

⁴⁵ See David J. Barron, *Foreword: Blue State Federalism at the Crossroads*, 3 HARV. L. & POL'Y REV. 1 (2009) ("The subprime crisis? Many state and local governments were relatively quick to crack down on predatory lending, but they soon found the nation's Comptroller of the Currency standing in their way.") (citing *Am. Fin. Servs. v. City of Oakland*, 104 P.3d 813 (Cal. 2005) (describing the efforts of Oakland to regulate the secondary market for subprime mortgages); cf. Jonathan D. Glater, *Lender Agrees to Contribution of \$ 2 Million to a Student Fund*, N.Y. TIMES, Aug. 1, 2007, at A13 (describing New York State Attorney General Andrew Cuomo's efforts to crack down on abusive lending in the student loan industry); see also Catherine M. Brennan & Meghan S. Musselman, *Consumer Credit: Preemptions and Regulations*, MD. B.J., Nov.-Dec. 2008, at 18, 20.

Tenth Amendment as providing an answer to the preemption question.⁴⁶ This combination of the interest of states' rights and the interest of progressivism in the context of consumer protection laws, therefore, has created some strange bedfellows for this debate.

III. *WATTERS V. WACHOVIA BANK*

A. *The Decision of Watters v. Wachovia Bank*

In *Watters v. Wachovia Bank*, the Supreme Court addressed the question of whether Wachovia Bank's "mortgage lending activities remain outside the governance of state licensing and auditing agencies when those activities are conducted, not by a division or department of the bank, but by the bank's operating subsidiary."⁴⁷ The court answered that question, in a five-to-three decision,⁴⁸ in the negative, largely stemming from the conclusion that national banks are federal instrumentalities and that there should be a presumption in favor of preemption from a concern for protecting national banks from burdensome state regulatory interference.⁴⁹ The court therefore included subsidiaries of national banks as being a "national bank" for the purpose of the National Bank Act and HOLA. Therefore, subsidiaries of national banks are not subject to any visitorial powers,⁵⁰ except as provided by federal law.⁵¹

⁴⁶ Keith R. Fisher, *Article: Towards a Basal Tenth Amendment: A Riposte to National Bank Preemption of State Consumer Protection Laws*, 29 HARV. J.L. & PUB. POL'Y 981 (2006). "One fundamental source of authority that, in theory, would vitiate OCC's assertion of preemption, but is often overlooked by the courts, is the Tenth Amendment. This Article suggests that the rescue of that Amendment from its current undeserved desuetude is in order. Accomplishing such a resurrection requires an analytical framework, and such a framework can be distilled from the Framers' commentary and debates. It may, particularly in light of the centrality of judicial review to the Framers' federalism design, provide the Tenth Amendment with substantive content that the courts can credibly enforce."

⁴⁷ *Watters*, 550 U.S. at 7.

⁴⁸ Justice Thomas did not partake in the decision, reportedly because his son was employed by Wachovia Bank. See Michael C. Tomkies, Ralph T. Wutscher & Elizabeth L. Anstaett, *Preemption and Federalism Developments: Watters Under the Bridge*, 63 BUS. LAW. 703, 704 (2008) (citing Linda Greenhouse, *Ruling Limits State Control of Big Banks*, N.Y. TIMES, Apr. 18, 2007, at C2).

⁴⁹ See Tomkies, *supra* note 48, at 705 (citing *Watters*, 550 U.S. at 18).

⁵⁰ "Visitorial powers" refers to the authority to examine, supervise, regulate, require information from and take enforcement action against a bank. *Special Interest—On Preemption and Visitorial Powers*, QUARTERLY JOURNAL, Mar. 2004, available at www.occ.treas.gov/qj/qj23-1/3-SpecialInterest.pdf.

⁵¹ 12 U.S.C. § 484(a) (2006) ("No national bank shall be subject to any visitorial powers except as authorized by Federal law . . .").

Petitioner Linda Watters,⁵² the state of Michigan's representative for the case, characterized Wachovia's wholly-owned subsidiary as an "affiliate" of the national bank.⁵³ If it the operation was an "affiliate," it would be subject to multistate control.⁵⁴ The court disagreed with this characterization on the grounds that 12 U.S.C. § 24 authorizes national banks to use nonbank operating subsidiaries.⁵⁵ Furthermore, Watters contended that if Congress meant to deny state visitorial powers, it would have included affiliates in the National Banks Act's⁵⁶ ban on state regulation.⁵⁷ The Court rejected that contention on two grounds. First, the Court took exception to Watters' reliance on the intent of the 1864 Congress in enacting the statute, because operating subsidiaries were not authorized until 1966.⁵⁸ Secondly, the Court took the view that because Congress made a clear distinction between what a subsidiary may do and what other types of affiliates may do in the National Bank Act, Watters was incorrect to characterize the operating subsidiary as an "affiliate."⁵⁹ The Court concluded that the National Bank Act protects a national bank's engagement in the "business of banking," whether conducted by the bank itself or an operating subsidiary that is authorized by law to engage in the

⁵² *Watters*, 550 U.S. at 21 (Stevens, J., dissenting) (Watters was the Commissioner of the Michigan Office of Insurance and Financial Services).

⁵³ *Id.* at 14.

⁵⁴ *Id.* ("Watters characterizes them simply as "affiliates" of national banks, and contends that even though they are subject to OCC's superintendence, they are also subject to multistate control.").

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ 12 U.S.C. § 484(a) (2006) (The Code on mentions national banks: "No national bank shall be subject to any visitorial powers except as authorized by Federal law.").

⁵⁸ *Watters*, 550 U.S. at 18 (The majority of Ginsburg, Kennedy, Souter, Breyer and Alito did not take an Originalist approach to this issue: "Over the past four decades, during which operating subsidiaries have emerged as important instrumentalities of national banks, Congress and OCC have indicated no doubt that such subsidiaries are "subject to the same terms and conditions as national banks themselves).

⁵⁹ *Id.* at 18-19: "The NBA broadly defines the term "affiliate" to include "any corporation" controlled by a national banks, including a subsidiary. An operating subsidiary is therefore one type of "affiliate." But unlike affiliates that may engage in functions not authorized by the NBA, e.g., financial subsidiaries, an operating subsidiary is tightly tied to its parent by the specification that it may engage only "in the business of banking" as authorized by the act."

(citing 12 U.S.C. § 221a(b) (2006); 12 U.S.C. § 24a(g)(3)(A) (2006); 12 C.F.R. §5.34(e)(1)(2006)).

same actions.⁶⁰ Finally, the Court rejected Watters' claim under 12 CFR §7.4006⁶¹ that state law should apply because Federal law or the OCC regulation does not provide for preemption on the grounds that regulation of national bank operations is a "prerogative of Congress under the Commerce and Necessary and Proper Clauses."⁶²

In the dissenting opinion, Justice Stevens⁶³ proceeded from an opposite presumption against federal preemption of state law, noting the concern for the potential impact an alternative decision would have on competitive equality between state and federal institutions.⁶⁴ The dissent focused on the fact that there had been no action from Congress immunizing subsidiaries of national banks from state laws and that there was no evidence that compliance with state laws would be unduly burdensome for Wachovia's mortgage activities sufficient to find that the subsidiary should not be preempted by state law.⁶⁵ The dissent pronounced more of an originalist opinion, concluding that preemption should not be extended to operating subsidiaries because there was no express statutory authority providing for federal preemption.⁶⁶

⁶⁰ *Watters*, 550 U.S. at 19 ("[a] national bank has the power to engage in real estate lending through an operating subsidiary, subject to the same terms and conditions that govern the national bank itself.").

⁶¹ 12 C.F.R. § 7.4006 (2006) (Unless otherwise provided by Federal law or OCC regulation, State laws apply to national bank operating subsidiaries to the same extent that those laws apply to the parent national bank.).

⁶² *Watters*, 550 U.S. at 21 (citing *Citizens Bank v. Alafabco Inc.*, 539 U.S. 52, 58 (2003) (per curium)).

⁶³ *Watters*, 550 U.S. at 21 (Stevens, J., dissenting) (Justice Stevens was joined by Justice Roberts and Scalia).

⁶⁴ See Tomkies, *supra* note 48, at 706 (citing *Watters*, 550 U.S. at 23 (Stevens, J., dissenting)).

⁶⁵ *Id.* at 23 (Until today, we have remained faithful to the principle that nondiscriminatory laws of general application that do not "forbid" or "impair significantly" national bank activities should not be pre-empted.) (citing, e.g., *Barnett Bank, N. A. v. Nelson*, 517 U.S. 25 (1996)).

⁶⁶ See G. Marcus Cole, *Protecting Consumers from Consumer Protection: Watters v. Wachovia Bank*, 270 CATO SUP. CT. REV. 251, 261-62 (2007) (concluding that the very question that served as the point of disagreement between the majority and the dissent was "whether a state-chartered operating subsidiary, which is never mentioned by any federal statute (except Glass-Steagall's blanket prohibition of them), could nevertheless invoke the sanctuary of federal preemption when a state attempts to enforce state banking regulations on it.").

B. *Various Interests Define Issue of Watters v. Wachovia Bank Differently*

Commentators were not in as much agreement over the central issue in *Watters v. Wachovia Bank* as the Court was.⁶⁷ Some commentators focused on doctrinal issues of the case to find that the decision was unreasonable.⁶⁸ Others found the central issue to be more about practical matters, such as whether an operating subsidiary with a national bank parent will obtain a competitive advantage over banks operating in the same state without a parent,⁶⁹ or whether states should have regulatory authority because they are better able to protect consumers.⁷⁰ Some saw the dividing line between the majority and minority as the majority worrying about duplicative and burdensome regulation that would result without federal preemption and the minority worrying about the loss of states engaging in competitive regulatory-setting if they are not able to regulate operating

⁶⁷ *Id.* at 253 (arguing that the central issue in *Watters* was a policy choice of limiting or enhancing state consumer protection legislation disguised as a doctrinal one (i.e., federalism, originalism vs. nonoriginalism, or judicial activism vs. judicial passivity)).

⁶⁸ Tomkies, *supra* note 48, at 707 (the authors focus on the extent to which preemption must be based on specific statutory authority, Seemingly a doctrinal issue); see also Kim, *supra* note 41, at 280 (“[T]his paper argues that the OCC’s construction is contrary to law and is unreasonable given the plain language of the NBA, precedential case law and the structure of the NBA.”).

⁶⁹ Timothy D. Kravetz, *Recent Decisions: National Bank Operating Subsidiaries Are Subject to Exclusive Visitorial Authority by OCC as NBA and OCC Regulations Preempt State Visitorial Authority Law: Watters v. Wachovia Bank*, 46 DUQ. L. REV. 279 (2009) (arguing that while the competitive equality argument is sound). “Ultimately, however, such arguments failed on sound reasoning by Justice Ginsburg and the majority. In terms of competitive equality, it does not *Seem* that operating subsidiaries will obtain a competitive advantage. For instance, while Wachovia Mortgage for six years operated under the superintendence of Watters in Michigan, it was not subject to OCC superintendence. If the minority view had prevailed, Wachovia Mortgage would have been subject to both while its state registered competitors were only subject to state regulation, arguably a competitive disadvantage.” *Id.* (citing *Watters*, 550 U.S. at 18; Brief for the Nat’l Ass’n of Realtors as Amicus Curiae Supporting Petitioner at 1415, *Watters v. Wachovia Bank, N.A.*, 550 U.S. 1 (2006) (No. 05-1342)).

⁷⁰ Cole, *supra* note 66, at 253 (“the real issue is whether, given our national credit markets, states should have the extensive authority to impose cumbersome, expensive, and indeed, irrational regulation on operating subsidiaries of national banks.”).

subsidiaries.⁷¹ Regardless of the value of these opinions, the divergent determinations as to what the real issue of *Watters v. Wachovia Bank* was indicate that the decision divided virtually all interests concerned with baking regulation.

The interests of the Originalists versus the non-Originalists were divided, for example, between those who wanted to deny preemption because there was no express authority for the OCC's construction⁷² and those who favored preemption based on implied authority and the notion that the intent of the 1864 Congress should have no bearing on the matter because operating subsidiaries were not around until the mid-20th century.⁷³ For traditional conservatives, this case created a divide between Federalists who wanted to scale back preemption powers for federal agencies and Libertarians who favored preemption because of the recent explosion of state consumer protection laws.⁷⁴ Similarly, for the same reasons, Federalists who favored scaling back preemption were put at odds with similarly-situated traditionally conservative economic interests who favor less intrusive federal law over state law and therefore are for preemption.⁷⁵

These divergent interests that even cut across traditional agreeable positions indicate that the issue of *Waters v. Wachovia Bank* is not as simple as it may seem. Therefore, the general question of whether federal law should preempt state law for operating subsidiaries of national banks, if addressed by forthcoming legislation, will also have divergent interests that cut across traditionally harmonious interests.

IV. THE DUAL BANKING SYSTEM THROUGH A PREDATORY LENDING LENS: STATE VS. FEDERAL

For some, the difference between federal and state consumer laws is characterized as the difference between experimentation and progressive state action and deregulation, and federal regulation.⁷⁶ Others see the

⁷¹ See *id.* at 262-63 (concluding, however, that "beneath the surface a different policy debate was brewing . . . The dissent accurately identifies the risks to federalism posed by the Court's holding.").

⁷² Tomkies, *supra* note 48, at 707; Kim, *supra* note 41, at 280.

⁷³ *Watters*, 550 U.S. at 18.

⁷⁴ Cole, *supra* note 66, at 251. ("Put simply, the choice was one between form and function, federalism and freedom . . . [t]his difficult choice divides not just the Court but libertarians from Conservatives.").

⁷⁵ *Id.* ("Should the state maintain significant power to regulate state chartered subsidiaries of national banks, even if that meant the occasional enforcement of misguided debilitating state consumer protection laws?").

⁷⁶ Christopher L. Peterson, *Federalism and Predatory Lending: Unmasking the Deregulatory Agenda*, 78 TEMP. L. REV. 1, 8 (1995) ("The thesis of my argument is that current efforts to preempt state law have little or nothing to do with federalism

balance of power between the federal and state consumer laws as a value in and of itself, as it affords banks the opportunity to “forum shop” for the best regulation, and differing laws compete to attract those banks, thus creating a regulatory environment that promotes competition.⁷⁷ Characterized in these two lights, the dual banking system has created either an opportunity for different levels of government to experiment with new regulations to protect consumers or a system whereby different levels of government “race to the bottom” in an effort to compete for banks to regulate by providing the least burdensome regulation.

A. *The Dual Banking System*

The dual banking system gives banks a choice as to the set of laws and administrators under which they will operate.⁷⁸ Importantly, banks are able to do this both when they start up or as an existing bank; a state-chartered bank may withdraw from the Federal Reserve System for example under reciprocity statutes, national banks can convert into state

in general or uniformity in particular, but are, in fact, simply efforts to deregulate.”).

⁷⁷ Cole, *supra* note 66, at 275-76. “Explaining that the opportunity for state chartered lending institutions to ‘flee the jurisdiction’ by becoming acquired by a nationally chartered bank is not ‘forum shopping’ in the pernicious meaning of the phrase. Forum shopping is bad when it occurs *ex post*, when parties to a transaction seek a favorable outcome by seeking a biased arbiter. On the contrary, *ex ante* forum shopping is what federalism is all about. Parties should exercise their constitutional right to interstate travel, for example, and ‘vote with their feet’ when encountering an inhospitable legal or regulatory climate. Debtors do this all the time. Why should creditors be different? In other words, preemption of state banking law in the narrow case of wholly owned operating subsidiaries of national banks may actually *promote and enhance* federalism, by providing lenders with an *ex ante* choice of legal regime, one that forces regulators to compete for their ‘business.’”

(citing, for example, G. Marcus Cole, *The Federalist Cost of Bankruptcy Exemption Reform*, 74 AM. BANKR. L.J. 227, 229 (2000) (discussing “the market for deadbeats” by considering how variations in laws can facilitate exit strategies for certain kinds of debtors). See also Frank H. Buckley & Margaret F. Brinig, *The Market for Deadbeats*, 25 J. LEGAL STUD. 201 (1996) (analyzing the factors that cause debtors to migrate to more favorable jurisdictions).

⁷⁸ Kenneth E. Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1, 8 (1977) (“The described regulatory diversity in effect allows new banks to choose the set of laws and administrators under which they will operate. For example, a group wishing to enter the banking business may apply to the Comptroller for a national bank charter or to the state for a state bank charter.”).

banks if the state law allows conversion.⁷⁹ These justifications are seemingly focused on the bank's side of the story, as they normally center on the idea of protecting banks from restrictive regulation,⁸⁰ or that it gave banks a chance to avoid arbitrary supervision.⁸¹ From the consumer's perspective, the opportunity for banks to pick and choose what regulations and administrators could be seen as beneficial, if the result is decreased costs because banks are not subject to burdensome regulation.⁸² Alternatively, that same ability for banks to pick and chose their regulations may be harmful to the consumer if those regulations would have provided the consumers more protection and that protection is worth more than the costs of the regulation.⁸³ Therefore, it is beneficial to examine the nature of state versus federal consumer protections laws for the purposes of this debate.

B. Predatory Lending Laws

One example that may expose the effect that the dual banking system has on consumers and on banks is the predatory lending environment. Here, borrowers lend to homeowners who frequently cannot

⁷⁹ *Id.* at 8-9 ("Perhaps less evident—but in practice much more important—is the fact that *existing* banks can *change* their laws and regulators") (citing 12 U.S.C. § 214(c) (1970) (2006); CAL. FIN. CODE §§ 2090, 2092 (West 1968); 16 Ill. COMP. Stat. 1/2-120 (1973); N.J. STAT. ANN. § 17:9A-154.1 (West 1963); N.Y. BANKING LAW § 137 (McKinney 1971); OHIO REV. CODE ANN. § 1121.01-.04 (LexisNexis 1968); 7 PA. STAT. ANN. § 1709 (West 1967)).

⁸⁰ Scott, *supra* note 78, at 12 (citing *Consolidation of Bank Examining and Supervisory Functions: Hearings on H.R. 107 and H.R. 6885 Before the Subcomm. on Bank Supervision and Insurance of the H. Comm. on Banking and Currency, and Before the H. Comm. on Banking and Currency*, 89th Cong. 120 (1965) (statement of Archie K. Davis).

⁸¹ *Id.* (citing *Consolidation of Bank Examining and Supervisory Functions: Hearings on H.R. 107 and H.R. 6885 Before the Subcomm. on Bank Supervision and Insurance of the H. Comm. on Banking and Currency, and Before the H. Comm. on Banking and Currency*, 89th Cong. 120 (1965) (statement of Ralph Zaun).

⁸² Richard L. Peterson, *The Costs of Consumer Credit Regulation* (Issues in Banking Regulation, Reprint 13, 1979), available at www.sbp.gwu.edu/research/centers/fsrp/pdf/Reprint13.pdf ("In the short-run, commercial banks and taxpayers bear the costs of consumer credit regulation and enforcement. In the longer-run, the costs of regulation are passed on to consumers in one way or another. Bank management's who find consumer loan activities more costly, less efficient and, therefore, less profitable to operate will either curtail such operations and divert their capital to more profitable operations or else take steps to increase the profitability of their consumer loan operations.").

⁸³ See Nicholas Bagley, *Crashing the Subprime Party: How the Feds Stopped the States from Averting the Lending Mess*, SLATE, Jan. 24, 2008, <http://www.slate.com/id/2182709/>.

pay their loans, however "predatory" loans are often hard to precisely define.⁸⁴ Predatory lending is a pressing problem that garners much political and media attention because the practice is heavily concentrated in low-income neighborhoods and it impacts the elderly and racial minorities disproportionately.⁸⁵ Predatory lending has been estimated as costing consumers around \$9.1 billion annually in excess payments.⁸⁶

There are many ways the federal and state governments try to prevent predatory lending, or at least ameliorate its consequences when it does occur.⁸⁷ One commentator, Christopher L. Peterson, compiled a study of contemporary American law addressing the problems of predatory home lending to conclude that there were roughly seven different principle strategies employed [(1) debtor amnesty, (2) restrictions on permissible contractual provisions, (3) anti-discrimination laws, (4) charitable lending, (5) facilitation of cooperative credit institutions, (6) anti-deception laws, and (7) price disclosure.]⁸⁸

With amnesty-based policies, the government attempts to protect the debtor by limiting the ability of creditors to collect debts.⁸⁹ A government might also attempt to protect consumers from predatory lending by limitations on contracting, i.e., prohibiting unfair or abusive

⁸⁴ Jonathan L. Entin & Shadya Y. Yazaback, *City Governments and Predatory Lending*, 34 FORDHAM URB. L. J. 757, 757-59 (2007) ("Defining predatory lending is difficult for two reasons. First, loan attributes may or may not be "predatory" depending on the sophistication or financial position of the borrower. Second, the definition of predatory lending cannot be static because the lending market is always evolving in light of technological, regulatory, and judicial advancements.").

⁸⁵ *Id.* (citing HUD-TREASURY TASK FORCE ON PREDATORY LENDING, CURBING PREDATORY HOME MORTGAGE LENDING 47 (2000), available at <http://www.huduser.org/Publications/pdf/treasrpt.pdf>; Paul S. Calem et al., *The Neighborhood Distribution of Subprime Mortgage Lending*, 29 J. REAL EST. FIN. & ECON. 393, 401 (2004); Paul S. Calem et al., *Neighborhood Patterns of Subprime Lending: Evidence from Disparate Cities*, 15 HOUSING POL'Y DEBATE 603, 611 (2004)).

⁸⁶ Burlingame, *supra* note 32, at 461 (citing ERIC STEIN, QUANTIFYING THE ECONOMIC COSTS OF PREDATORY LENDING, REPORT FOR COALITION FOR RESPONSIBLE LENDING (2001), available at <http://www.responsiblelending.org>).

⁸⁷ Peterson, *supra* note 76, at 31. However, it should be noted that these strategies, even when taken in combination with each other, are inadequate. *Id.* at 61 ("[t]he bottom line is that each of the strategies discussed so far, even when considered collectively, suffer from significant drawbacks that leave many borrowers unprotected.").

⁸⁸ *Id.* ("Roughly speaking, we have used seven principle strategies to prevent predatory lending, or at least to ameliorate its consequences when it does occur.").

⁸⁹ *Id.*

contractual provisions.⁹⁰ Additionally, federal and state governments may attempt to prevent lenders from targeting borrowers based on an impermissible bias through antidiscrimination laws.⁹¹ Federal and state governments may also encourage banks to help meet the credit needs of those who would not ordinarily receive a good rate through charitable-lending rewards.⁹² Governments also facilitate cooperative credit institutions where banks pool resources into a credit union and therefore are able to create pools of low-cost funds from which to borrow, thereby insulating themselves from financial predators.⁹³ Or governments may facilitate the use of anti-deception law, like the intentional tort of fraud, as a defense for vulnerable consumer borrowers.⁹⁴ Finally, federal and state governments may attempt to protect consumers through disclosure and education statutes that make it easier for consumers to know what they are signing up for and compare products.⁹⁵

Some commentators, including the commentator that compiled this list⁹⁶ consider these remedies inadequate because of the special situation subprime borrowers are in, and because these remedies are designed to help *prime* borrowers.⁹⁷ For example, because subprime borrowers pose more significant credit risks to creditors, subprime loans are often more complicated than traditional loans, as they often have additional fees and

⁹⁰ *Id.* at 34.

⁹¹ *Id.* at 39. (At the federal level, the primary legislation includes the Fair Housing Act (FHA) and the Equal Credit Opportunity Act (ECOA)).

⁹² *Id.* at 45 (The most prominent current example of this strategy with respect to predatory home mortgage lending is the federal Community Reinvestment Act (CRA). Congress concluded that public bank charters and deposit insurance create a "continuing and affirmative obligation to help meet the credit needs of the local communities in which they are chartered.").

⁹³ *Id.* at 45 (Peterson goes on to explain, "[t]hese organizations, both federal and state, have not prevented the recent entrenchment of predatory home mortgage lending. This may be in part because the most vulnerable borrowers are often beyond the reach of cooperative lenders.").

⁹⁴ Peterson, *supra* note 76, at 46.

⁹⁵ *Id.* at 51-53 (describing the Truth in Lending Act as the primary American consumer credit regulation price disclosure statute) (citing 15 U.S.C. §§ 1601-1667 (2006)).

⁹⁶ Peterson, *supra* note 87.

⁹⁷ Arielle L. Katzman, Note, *A Round Peg for a Square Hole: The Mismatch Between Subprime Borrowers and Federal Mortgage Remedies*, 31 CARDOZO L. REV. 497, 544 (2009) ("[M]any current remedies were designed for prime borrowers, and certain statutory provisions and regulations fail to meet the particular needs of subprime borrowers"); see also Jessica Fogel, Comment, *State Consumer Protection Statutes: An Alternative Approach to Solving the Problem of Predatory Mortgage Lending*, 28 SEATTLE U. L. REV. 435, 438 (2005).

restrictive terms.⁹⁸ Similarly, subprime borrowers are generally considered more vulnerable due to their economic status and the probability that they may have other problems or they lack experience and knowledge of complex financial transactions.⁹⁹ Because these problems seemingly create the perfect storm¹⁰⁰, predatory lending represents an excellent opportunity to expose the dynamics of the dual banking system and how it promotes competition for banks and protects consumers.

C. Federal Predatory Lending Laws

There are three major federal laws that govern predatory lending: The Truth in Lending Act (TILA),¹⁰¹ The Real Estate Settlements Procedures Act (RESPA),¹⁰² and the Home Ownership and Equity Protection Act¹⁰³ (HOEPA). TILA, passed in 1968, requires mortgage lenders to disclose to borrowers certain information to facilitate an understanding of the “true” cost of a loan and to help borrowers compare the offer to other lenders.¹⁰⁴ Similarly, RESPA, passed in 1974, which

⁹⁸ Katzman, *supra* note 97, at 500 (citing Truth in Lending, 73 Fed. Reg. 44,522, 44,524 (July 30, 2008) (“[P]roducts in the subprime market tend to be complex, both relative to the prime market and in absolute terms, as well as less standardized than in the prime market.”)).

⁹⁹ *Id.* (citing David Feldman & Shulamith Gross, *Mortgage Default: Classification Trees Analysis*, 29 J. of Real Estate Economics 368-371 (2004) (discussing survey evidence that borrowers with subprime loans are more likely to have experienced major adverse life events (marital disruption; major medical problem; major spell of unemployment; major decrease of income) and often use refinancing for debt consolidation or home equity extraction); Heather M. Tashman, *The Subprime Lending Industry: An Industry in Crisis*, 124 BANKING L.J. 407, 413 (2007)).

¹⁰⁰ By this I mean because sub-prime borrowers are likely to default on their loans, creditors must account for this by making it even harder from the borrowers to pay their loans. Therefore, the circumstantial result is that predatory lending is actually making it harder for subprime borrowers to pay off their loans.

¹⁰¹ 15 U.S.C. § 1501 (2006); OFFICE OF THE COMPTROLLER OF THE CURRENCY, THE TRUTH IN LENDING HANDBOOK (2008), *available at* www.occ.treas.gov/handbook/til.pdf. The TILA, 15 U.S.C. § 1601, was enacted on May 29, 1968, as title I of the Consumer Credit Protection Act (Pub. L. 90-321). The TILA, implemented by Regulation Z (12 C.F.R. § 226), became effective July 1, 1969.

¹⁰² 12 U.S.C. §§ 2601-17 (2006).

¹⁰³ 12 C.F.R. § 226.35(a) (2006).

¹⁰⁴ Katzman, *supra* note 97, at 508; 15 U.S.C. § 1601(a) (2006) (prior to the extension of credit, lenders must disclose to the borrower information such as the loan’s APR, finance charges, the total amount financed the number of payments, and the payment schedule); *see also* Patricia A. McCoy, *Rethinking Disclosure in a*

applies to federally-regulated mortgage loans,¹⁰⁵ requires certain disclosures at different points of a loan transaction.¹⁰⁶

In the subprime lending environment these statutes fall short of providing substantial relief as disclosure-based requirements are not a good match for the intricacies of subprime lending¹⁰⁷ and the requirements on lenders are also hard to enforce.¹⁰⁸ Additionally, the remedies available under these provisions do not provide much help, as they do not help the borrower stay in their home and avoid foreclosure.¹⁰⁹ Therefore, the federal legislative framework of these two acts does not provide much help to subprime borrowers outside of disclosure requirements, and any cause of action they may have is seemingly blocked either because the statutes do not address the root cause or the remedy would be meaningless given the economic situation of the borrower.¹¹⁰

Finally, HOEPA, which amended TILA in 1994, prohibits the initial lender from certain practices and requires lenders to consider the borrower's ability to repay the loan *prior* to issuing the loan.¹¹¹ The primary purpose of the Act was to reverse the practice of lenders targeting residents "within certain geographic boundaries based on income, race or ethnicity,"¹¹² and giving these targeted borrowers unfair terms.¹¹³ While

World of Risk-based Pricing, 44 HARV. J. ON LEGIS. 123, 131-38 (2007) (detailing intricacies of timing for disclosures).

¹⁰⁵ Katzman, *supra* note 97, at 508 (citing 12 U.S.C. § 2602(1) (2006) (establishing criteria for classification as a federally related mortgage loan). This definition includes more than loans by federally regulated lenders and should cover most subprime loans. See 2 WEST'S FED. ADMIN. PRAC. § 1563 (4th ed. 2008) (noting that the term encompasses virtually every residential real estate transaction closing in the United States, including refinancings and subordinate mortgages.).

¹⁰⁶ Katzman, *supra* note 97, at 508.

¹⁰⁷ *Id.* at 510 (citing Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2250 (2007)) (assessing how "Consumer Protection Laws Presume an Antiquated Model of Finance," which "hints at a fundamental structural problem in the law.").

¹⁰⁸ Katzman, *supra* note 97, at 510 ("This narrow statutory approach limits available claims and erects obstacles for establishing claims where available, in a way that clashes with the reality of subprime transactions.").

¹⁰⁹ *Id.* (Explaining that the staying in the home and avoiding foreclosure is not an available remedy despite the fact that for most subprime borrowers).

¹¹⁰ *Id.* at 518-23.

¹¹¹ *Id.* (citing 15 U.S.C. § 1639 (2006) (enumerating additional disclosures and warnings for qualifying loans along with other limitations such as no balloon payments, prepayment penalties, or negative amortization)).

¹¹² This practice is often referred to as "redlining."

¹¹³ Laura Dietrich, Note, *Massachusetts's New Predatory Lending Law and the Expanding Rift Between Federal and State Lending Protection*, 26 B.C. THIRD WORLD L.J. 169, 185 n.129 (2006) (citing S. REP. NO. 103-169, at 21 (1994), reprinted in 1994 U.S.C.C.A.N. 1881, 1905).

HOEPA does impose additional requirements and limitations on “high cost mortgages,” the Act explicitly excludes three major types of mortgages—home purchase mortgages, reverse mortgages, and open-ended credit mortgages—from protection.¹¹⁴ Furthermore, the Act very narrowly defines what constitutes a “high cost mortgage,” and as a result, only extremely egregious loans are covered.¹¹⁵

HOEPA imposed additional disclosure requirements for “high cost loans”, including the mandate that the lender disclose to the potential borrower that: they are not required to complete the transaction, that there is a possibility that they could lose their home through foreclosure, and the annual percentage rate, the monthly payment amount, and the maximum amount to which the monthly payment could be increased during the course of the loan.¹¹⁶ Additionally, HOEPA attempts to protect borrowers from high pressure sales tactics by requiring a three-day waiting period before the loan is finalized, giving the borrower a chance to take a step back and think about the loan.¹¹⁷ Finally, HOEPA prohibits certain misleading terms from these high cost mortgages that might disguise the actual cost of the loan.¹¹⁸

While HOEPA imposes more than just disclosure requirements, the narrow definition of what constitutes a “high priced mortgage” leaves out a substantial amount of abusive loans.¹¹⁹ Therefore, HOEPA was a step

¹¹⁴ *Id.* at 186-87 (citing 15 U.S.C. § 1602(aa)(1)).

¹¹⁵ *Id.* at 187 n.138 (citing 15 U.S.C. § 1602(aa)) (“[A]n otherwise qualifying mortgage is regulated only if its interest rate exceeds the Treasury’s rate of interest by more than ten percent, or if the total points and fees, paid by the consumer at or before closing, exceed eight percent of the total loan amount or \$400, whichever is greater.”).

¹¹⁶ *Id.* at 187 n.141-42 (citing S. REP. NO. 103-169, at 25).

¹¹⁷ *Id.* at 188 n.145 (citing S. REP. NO. 103-169, at 25).

¹¹⁸ *Id.* (The following terms are prohibited: “prepayment penalties, points on loan amounts refinanced, default interest rates above the rate prior to the default, balloon payments, negative amortization, or prepayment of more than two of the periodic payments”) (explaining, however, that the prohibition of these terms is not absolute. Congress delegated to the Federal Reserve Board broad discretionary authority to “exempt specific mortgage products or categories of products from the prohibitions.”).

¹¹⁹ *Id.* at 188-89 (citing Eric Stein, *Quantifying The Economic Cost of Predatory Lending*, 7 COALITION FOR RESPONSIBLE LENDING 200, <http://www.responsiblelending.org/pdfs/Quant10-01.pdf> (“Fannie Mae, the [North Carolina] General Assembly, and Washington Mutual have all found that points and fees greater than five percent are abusive.” Additionally, the Coalition for Responsible Lending believes that points and fees above three percent are abusive and constitute predatory lending.)).

towards accounting for the special needs of the predatory lending problem for the federal government in that it recognized that disclosure alone does not protect the subprime borrower. The shortcomings of this law, however, become clear when compared to subsequent state laws. It becomes clear, then, that state law is more responsive to the needs of borrowers and federal law is more responsive to the needs of lenders.

D. State Predatory Lending Laws

The inadequacy of federal law for regulating subprime lending has been recognized by many state legislatures and agencies. That recognition, paired with rising consumer complaints about the problem of predatory lending, has caused many state and local regulators to respond with their own laws.¹²⁰ Generally speaking, state predatory lending laws are more applicable to the subprime situation because they limit what contracts the state will honor in the context of home mortgage loans by broadly defining what is a “high cost mortgage” and paying less attention to disclosure.¹²¹

North Carolina was the first state to adopt an anti-predatory lending statute in 1999 when they enacted S. 1149 in 1999.¹²² The law, enacted as part of the state’s general usury law,¹²³ placed restrictions and limitations on certain types of home loans as well as general restrictions on all home loans.¹²⁴ The statute restricts borrowers from: loan flipping,¹²⁵ financing of

¹²⁰ See Burlingame, *supra* note 32, at 468 (citing Elizabeth Renaut, *Toward One Competitive and Fair Mortgage Market: Suggested Reforms in a Tale of Three Markets Point in the Right Direction*, 82 TEX. L. REV. 421, 422 (2003)) (“Most states entered the predatory lending arena Seeking to cure deficiencies associated with HOEPA. However, upon further study many states concluded that the actual problem runs much deeper and have sought to impose other requirements on potential predatory lenders. State legislators therefore seem to be more cognizant of the cognitive limitations and biases that consumers deal with in making financial decisions.”). See also Dietrich, *supra* note 113, at 200 (describing that the ultimate passage of a Massachusetts predatory lending law is the result of the “legislature’s recognition of the emergent need to stop the growth of abusive lending practices”) (citing Thomas Grillo, *Bill to Curb Predatory Lending Backed*, BOSTON GLOBE, Mar. 15, 2004, at B2 (describing support for the PHLPA bill)).

¹²¹ See Nicholas Bagley, Note, *The Unwarranted Regulatory Preemption of Predatory Lending Laws*, 79 N.Y.U. L. REV. 2274, 2299 (2004).

¹²² See Burlingame, *supra* note 32, at 468 (citing 1999 N.C. Gen. Sess. Laws 332 (codified at N.C. GEN. STAT. §§ 24-1.1A to 24-10.2 (2009))).

¹²³ Interest rate regulation.

¹²⁴ *Id.* (citing Donald C. Lampe, *Wrong From the Start? North Carolina’s “Predatory Lending” Law and the Practice vs. Product Debate*, 7 CHAP. L. REV. 135, 135 (2004); Donald C. Lampe, *The North Carolina “Predatory Lending” Usury Statute--S.B. 1149*, 55 CONSUMER FIN. L.Q. REP. 81 (2001)).

¹²⁵ *Id.* (citing N.C. GEN. STAT. § 24-10.2(c) (2009)); see also Julie L. Williams & Michael S. Bylsma *Federal Preemption and Federal Banking Agency Responses*

single premium insurance,¹²⁶ and encouraging default in the refinance of debt¹²⁷ for all types of home loan transactions. If a loan is considered a "high cost loan,"¹²⁸ there are further restrictions that limit what a creditor may offer. For example, a creditor may not offer a high cost loan until the borrower has received home-ownership counseling, and the creditor believes that the borrower can repay the loan.¹²⁹ Finally, the law also has a blanket prohibition against repayment penalties for home mortgage loans of \$150,000 or less.¹³⁰

Following North Carolina, many other states enacted similar versions of predatory lending laws.¹³¹ As of 2006, more than thirty states have adopted statutory or regulatory schemes designed to address predatory lending.¹³² However, the extent to which those laws differ from existing

to *Predatory Lending*, 59 BUS. LAW 1193 n.15 (citing, U.S. DEP'T OF TREASURY AND U.S. DEP'T HOUSING AND URBAN DEV., CURBING PREDATORY HOME MORTGAGE LENDING: A JOINT REPORT 73-74 (2000) [hereinafter Treasury-HUD Joint Report], available at <http://www.treas.gov/press/releases/reports/treasrpt.pdf>) (explaining that Loan flipping is generally understood to mean the refinancing of a loan for the main purpose of a lender garnishing additional fees at little or no economic benefit to the borrower.).

¹²⁶ *Id.* (citing N.C. GEN. STAT. § 24-10.2(b) (2009)).

¹²⁷ *Id.*

¹²⁸ *Id.* (explaining: "A North Carolina loan will be considered a high-cost loan, subject to the enhanced restrictions, if it meets any one of three triggers: (1) the APR is greater than ten percentage points above the comparable U.S. Treasury security; (2) the points and fees exceed five percent of the total loan amount; or (3) the prepayment penalty exceeds two percent of the amount prepaid.").

¹²⁹ *Id.* (citing C. Bailey King, Jr., *Preemption and the North Carolina Predatory Lending Law*, 8 N.C. BANKING INST. 377, 380 (2004) (in addition, high cost loans are subject to a variety of term restrictions, for example, both balloon payments and negative amortizations are prohibited); see also N.C. GEN. STAT. § 24-11.1E (2009)).

¹³⁰ See Dietrich, *supra* note 113, at 195 n.200 (citing Robert G. Quercia, Michael A. Stegman & Walter R. Davis, *Assessing the Impact of North Carolina's Predatory Lending Law*, 15 HOUSING POL'Y DEBATE 573, 597 (2004), available at http://www.fanniemae.foundation.org/programs/hpd/pdf/hpd_1503_Quercia.pdf).

¹³¹ *Id.* at 576-77 n.4.

¹³² See Julia P. Forrester, *Still Mortgaging the American Dream: Predatory Lending, Preemption, and Federally Supported Lenders*, 74 U. CIN. L. REV. 1303, 1319 (2006) (citing FLA. STAT. ANN. §§ 494.0079, 494.00791 (West Supp. 2005); GA. CODE ANN. § 7-6A-1 to 7-6A-13 (2004); N.C. GEN. STAT. § 24-1.1E (2003); N.J. STAT. ANN. §§ 46:10B-24 to 46:10B-35 (West Supp. 2005); N.Y. BANKING LAW § 6-1 (McKinney Supp. 2005); OHIO REV. CODE ANN. § 1349.25-1349.37 (2002); 63 PA. CONS. STAT. ANN. § 456.501-456.524 (West Supp. 2005)); see also, Butera & Andrews, [http:// www.butera-](http://www.butera-)

federal laws varies tremendously. For example, as of 2006, approximately eleven states have enacted predatory lending laws that are substantially similar to existing federal law or that they are supported by the subprime lending industry.¹³³ However, there are approximately eleven other states¹³⁴, as of 2006, that have enacted legislation that has been characterized as “moderate to strong.”

One of those “moderate to strong” laws, the Predatory Home Loan Practices Act, was passed in Massachusetts in August of 2004.¹³⁵ The law, like North Carolina’s, defines “high costs mortgages” and places restrictions and imposes requirements on these loans for both lenders and borrowers.¹³⁶ Importantly, the Massachusetts law broadly defines what constitutes a “high cost mortgage” as loans that either have annual interest rates in excess of eight percent, the yield on U.S. Treasury securities, or have total points and fees in excess of the greater of five percent of the total loan amount or \$400.¹³⁷ For “high cost loans,” the creditor must receive certification that the borrower attended counseling from a third-party nonprofit organization about the loan transaction.¹³⁸ Additionally, the law requires that lenders have a reasonable belief that the borrower will be able to meet the scheduled payments for the loan based on a number of financial factors.¹³⁹ The law also attempts to reduce loan flipping by prohibiting lenders from knowingly refinancing a home loan that was “consummated within the prior sixty months... unless the refinancing is in the borrower’s interest.”¹⁴⁰ Finally, the law also governs the remedies for victims of the law by preventing lenders from forcing borrowers to pursue their claims in particular forums that are more costly, less convenient “or more dilatory for

andrews.com/legislativeupdates/directory/State/Legislature/Bills/sbc/StateBillChart 2005.pdf (last visited Mar. 25, 2010).

¹³³ *Id.*

¹³⁴ *Id.* (these states are: Arkansas, Georgia, Illinois, Massachusetts, New Jersey, New Mexico, New York, North Carolina, South Carolina and West Virginia).

¹³⁵ Dietrich *supra* note 113, at 200 (citing Predatory Home Loan Practices Act, 2004 Mass. Acts 268).

¹³⁶ *Id.* at 200-01 (citing Predatory Home Loan Practices Act, 2004 Mass. Acts 268).

¹³⁷ *Id.* at 200.

¹³⁸ *Id.* at 201 (citing MASS. GEN. LAWS ch. 183C, § 3 (2004)).

¹³⁹ *Id.* at 202 n.270 (citing MASS. GEN. LAWS ch. 183C, § 4 (2004)) (the author goes on to explain that the lack of clear guidance as to how to determine whether a borrower will or will not be able to make a repayment could have the unintended consequence for reducing the amount of credit available because the lender may be hesitant); *see also* Ann McDonald, *State Anti-Predatory Lending Laws: More Harm Than Help* ASS’N OF COMTY. ORGANIZERS FOR REFORM NOW, Aug. 22, 2003, [http://www.acorn.org/index.php?id=8313&tx_ttnews\[pointer\]=1&tx_ttnews\[tt_news\]=9004&tx_ttnews\[backPid\]=2777&cHash=ba487865bc](http://www.acorn.org/index.php?id=8313&tx_ttnews[pointer]=1&tx_ttnews[tt_news]=9004&tx_ttnews[backPid]=2777&cHash=ba487865bc).

¹⁴⁰ *Id.* at 203 n.278 (citing MASS. GEN. LAWS ch. 183C, § (28)(c) (2004)).

the resolution of a dispute than a judicial forum.”¹⁴¹ This prevents lenders from forcing borrowers to submit their claims through arbitration, even when there is a mandatory arbitration clause, provided that arbitration is found to be more costly, dilatory or less convenient.¹⁴²

V. COMPARING FEDERAL AND STATE PREDATORY LENDING LAWS

Federal laws dealing with predatory lending seemingly pay too much attention to disclosure requirements, and when they do impose restrictions or requirements other than disclosure, they define “high cost” mortgages too narrowly to account for a substantial amount of abusive loans. In contrast, the state laws of North Carolina and Massachusetts have a broader definition of what constitutes a “high cost” loan.¹⁴³ Additionally, while the Home Ownership and Equity Protection Act requires a three-day cooling period before the loan is finalized,¹⁴⁴ both Massachusetts¹⁴⁵ and North Carolina¹⁴⁶ require that the borrower receive counseling and the lender to have a reasonable belief that the borrower will be able to make scheduled payments. For the subprime lending environment, the requirement of counseling is much more protective for borrowers than the requirement of a waiting period because counseling forces a borrower to discuss the loan with an expert who is better able to identify the pitfalls or

¹⁴¹ *Id.* at 203-04 (citing MASS. GEN. LAWS ch. 183C, §13 (2004)) (That “any provision of a home mortgage loan that requires a borrower to assert a claim or defense in “a forum that is less convenient, more costly, or more dilatory for the resolution of a dispute than a judicial forum . . . is unconscionable and void.”).

¹⁴² *Id.*

¹⁴³ *Id.* at 200 (“PHLPA is an aggressive response to the abusive lending practices that are most harmful to borrowers. Perhaps most significantly, PHLPA defines a “high cost mortgage” loan very broadly. High cost mortgage loans are defined as loans that either have annual interest rates in excess of 8% the yield on U.S. Treasury securities or have total points and fees in excess of the greater of five percent of the total loan amount or \$400. Thus, PHLPA defines high cost mortgage loans similarly to NCPLL, eschewing HOEPA’s much more narrow definition.”). (citing Predatory Home Loan Practices Act, 2004 Mass. Acts 268; MASS. GEN. LAWS ch. 183C, § 2 (2004)).

¹⁴⁴ See Dietrich *supra* note 113, at 187-88 n. 145 (citing S. REP. NO. 103-169, at 25).

¹⁴⁵ *Id.* at 200 (citing Predatory Home Loan Practices Act, 2004 Mass. Acts 268); *Id.* at 201 (citing MASS. GEN. LAWS ch. 183C, § 3 (2004)).

¹⁴⁶ See Burlingame, *supra* note 32, at 468 (citing C. Bailey King, Jr., *Preemption and the North Carolina Predatory Lending Law*, 8 N.C. BANKING INST. 377, 380 (2004) (In addition, high cost loans are subject to a variety of term restrictions, for example, both balloon payments and negative amortizations are prohibited); see also, N.C. GEN. STAT. § 24-11.1E (2003).

hidden dangers of the loan than the borrower.¹⁴⁷ This protection, however, is downplayed by the high frequency with which lenders change terms immediately before closing.¹⁴⁸

Furthermore, when comparing the growth or decline of predatory lending practices of North Carolina, after the enactment of its Predatory Lending law, the comparison with national trends makes it apparent that the state law is more protective than the federal. In a study conducted by the University of North Carolina at Chapel Hill, researchers found that North Carolina experienced a three percent decline in overall subprime loan origination compared to an increase at the national level.¹⁴⁹ The decline in subprime lending was caused by a twenty percent drop in subprime refinance lending as subprime home purchased lending experienced seventy-two percent growth.¹⁵⁰ The research concluded, however, that “since the most abusive subprime lending involves refinancing existing loans, we would expect a good law to result in a decline in home refinancing loans generally and in predatory refinancing loans in particular.”¹⁵¹ Therefore, the University of North Carolina researchers concluded that the post-law decline in refinance loans paired with a healthy growth in home purchases meant that the North Carolina predatory lending Law was a success.¹⁵²

Another indication of state governments being more active than the federal government is seen through the enforcement of predatory lending laws and the restitution and fines for predatory lending, and other consumer protection violations. Here too, states appear to be more active as the Director of Financial Institutions in the State of Washington, Helen P.

¹⁴⁷ See Dietrich *supra* note 113, at 201 (citing MASS. GEN. LAWS ch.183C, § 3 (2004)).

¹⁴⁸ *Id.* (“The counseling requirement, though beneficial, is not a panacea. For instance, counseling does not cue harms caused by a lender who uses outright deception by changing term immediately before closing.”).

¹⁴⁹ *Id.* at 190 n.174 (citing Robert G. Quercia, Michael A. Stegman & Walter R. Davis, *Assessing the Impact of North Carolina's Predatory Lending Law*, 15 HOUSING POL'Y DEBATE 573, 586 (2004), available at http://www.fanniemae.foundation.org/programs/hpd/pdf/hpd_1503_Quercia.pdf (“North Carolina's three percent decline is notable when compared with the increases in subprime lending that occurred in other states and regions. During the same time period, there was a seventeen percent increase in subprime loan originations. Similarly, there was an eighteen percent increase in subprime lending in the rest of the South. States bordering North Carolina also experienced increases in subprime lending that ranged between three percent and twenty five percent.”).

¹⁵⁰ *Id.*

¹⁵¹ *Id.* at 588; see also Dietrich *supra* note 113, at 198 (noting that subprime refinance loans are recognized as the form of loan that most frequently has predatory terms).

¹⁵² Dietrich *supra* note 113, at 201.

Howell, noted that “in 2002 alone, the states recovered over \$500 million in restitution and fines for predatory lending and other consumer protection violations, compared to only \$7 million collected by the OCC.”¹⁵³

The OCC has responded to claims about their lack of protection by stating that those state laws are detrimental to consumers and the economy because they decrease the amount of credit available¹⁵⁴ for low-income, high-risk borrowers, or increase its costs.¹⁵⁵ Regardless of the merits of this claim,¹⁵⁶ these statements, together with a comparison of the effect of the North Carolina law on subprime lending to trends at the national level, clearly indicate that, at least for states with “moderate to strong” consumer protection laws¹⁵⁷, state law provides more restrictions for mortgage lenders in the subprime context than the existing federal laws.

VI. WHY DO BANKS OPERATE THROUGH SUBSIDIARIES?

A. How often do they use Subsidiaries?

In 2005, information compiled by the Federal Reserve System indicates that mortgage companies received more than sixty percent of all home loan applications, despite the fact that such companies only made up

¹⁵³ See Dietrich, *supra* note 113, at 198 (citing CTR. FOR RESPONSIBLE LENDING, ANALYSIS OF OCC GUIDELINES ESTABLISHING STANDARDS FOR RESIDENTIAL MORTGAGE LENDING PRACTICES 4 (2005), available at http://www.responsiblelending.org/pdfs/pa-OCC_Guidelines-0205.pdf).

¹⁵⁴ The intent of this section is not to speculate as to whether more or less laws or enforcement actions are better for consumers; rather, it describes which regulatory environment banks would most prefer.

¹⁵⁵ See Burlingame, *supra* note 32, at 479 (citing Comptroller of Currency. *Economic Issues in Predatory Lending* (OCC Working Paper, 2003); Roberto G. Quercia, Michael A. Stegman & Walter R. Davis, *Assessing the Impact of North Carolina's Predatory Lending Law*, 15 HOUSING POL'Y DEBATE 573, 578-79 (2004) (discussing the results of various studies that have examined the impact of North Carolina's Predatory Lending law on the availability of subprime credit)).

¹⁵⁶ Interestingly, studies have found that a decrease in the total amount of predatory loans either does not decrease the total amount of credit or does not have a clear impact on the total amount of credit. See Burlingame, *supra* note 32, at 479 (citing Roberto G. Quercia, Michael A. Stegman & Walter R. Davis, *Assessing the Impact of North Carolina's Predatory Lending Law*, 15 HOUSING POL'Y DEBATE 573, 578-79 (2004) (discussing the results of various studies that have examined the impact of North Carolina's Predatory Lending law on the availability of subprime credit). See also *supra* pt. III.B, for a review of the main provisions of S. 1149.

¹⁵⁷ See *supra* pt. IV D.

around twenty percent of the total number of lenders.¹⁵⁸ Of those mortgage companies in that study, only fifteen percent were not affiliated with federally-regulated depository institutions, and they were therefore not subject to federal regulation.¹⁵⁹ While these numbers are largely speculative and hard to come by, the benefits for a nationally chartered bank engaging in predatory loan practices through an operating subsidiary is indicative of the tendency for banks to engage in such an action.

B. Motivations for Operating Through a Subsidiary

Given the widespread recognition of the problems associated with predatory lending, the risks associated with such a practice present challenges for banks seeking to supply subprime loans. Banks using operating subsidiaries, instead of fully integrating the lending operation into their company, do so in order to circumvent the risks that come from subprime lending.¹⁶⁰ The most significant advantage of a bank issuing its predatory loans through a subsidiary is to insulate the bank from the liability that comes from the riskier practice because the subsidiary has a separate legal status.¹⁶¹ Practically speaking, this allows a bank to avoid litigation risks that come from their predatory lending operation. Furthermore, banks can minimize reputational harm from their predatory lending operation, due to high rate of foreclosures, litigation and public awareness of their practice.¹⁶² Finally, the operating subsidiary, as a non-bank mortgage company, is sheltered from "safety and soundness regulations,"¹⁶³ such as the capital requirements that are applicable to the

¹⁵⁸ See Entin, *supra* note 84, at 781 (citing Robert B. Avery et al., *Higher-Priced Home Lending and the 2005 HMDA Data*, FED. RES. BULL. Sept. 2006, at A129) (noting that this study should be read with caution because it only covers eighty percent of the countries home lending.)

¹⁵⁹ *Id.*

¹⁶⁰ See Kim, *supra* note 41, at 283.

¹⁶¹ *Id.* (explaining that National banks have established operating subsidiaries basically to insulate themselves from the effect of the failure of the subsidiaries and thereby could maintain their safety and soundness.) (citing Rules, Policies and Procedures for Corporate Activities, 61 Fed. Reg. 60,342, 60,354 (Nov. 27, 1996) (explaining that a separate subsidiary structure can reduce risks of new activities by distinguishing the subsidiary's activities from those of the parent bank as a legal matter) (citation omitted)); see also *Watters*, 127 S. Ct. at 1585 (Stevens, J., dissenting) (explaining that "the primary advantage of maintaining an operating subsidiary as a separate corporation is that it shields the national bank from the operating subsidiaries' liabilities) (citing *United States v. Bestfoods*, 524 U.S. 51, 61 (1998)).

¹⁶² *Id.*

¹⁶³ *Id.* ("Also, §§ 23A and 24B of the Federal Reserve Act, which govern transactions between a bank and its affiliates, do not apply to the bank's transactions with its operating subsidiaries. Thus, for instance, banks can make

parent bank.¹⁶⁴ This exemption permits the subsidiary to obtain unlimited funds from the parent bank on favorable terms for the operating subsidiaries.¹⁶⁵ Therefore, a national bank operating through a subsidiary for their predatory loan practices is able to limit liability and criticism for their operation, and the subsidiary is offered more favorable regulatory environment with which to operate. Therefore, despite concrete numbers on the incidence of nationally chartered banks using operating subsidiaries, the benefits that come from such an organization make it clear that these subsidiaries have a sizeable role in the predatory lending environment.

C. State vs. Federal Law a Motivation as Well?

What are not addressed by these motivations are the advantages that come with federal regulations. For a state chartered mortgage company, becoming a subsidiary of a nationally-chartered bank comes with it the added bonus of having federal law preempt state law. While state laws are the result of calls for enhancing consumer protection, the OCC has a different motivation, as defined by their own mission statement – “to ensure a stable and competitive national banking system.”¹⁶⁶ This might explain why the OCC has echoed commentators who have stated that state consumer protection laws are detrimental to consumers and the economy because they decrease the amount of credit available for high-risk borrowers or they increase the cost of credit.¹⁶⁷ Also explaining this

transactions with their operating subsidiaries without the application of the percentage-of-capital limitations”) (citing 12 U.S.C. § 371c(a), (b) (2006) (“A bank's covered transactions--such as extension of credit and purchasing assets--with one affiliate and all affiliates cannot exceed ten percent and twenty percent of the bank's capital respectively. Also, covered transactions must be fully secured by qualifying collateral and basically the bank cannot purchase low-quality asset from affiliates.”)).

¹⁶⁴ *Id.* (citing OCC, MORTGAGE BANKING: COMPTROLLER'S HANDBOOK 5-6 (Mar. 1998), available at <http://www.occ.treas.gov/handbook/mortgage.pdf>; U.S. GEN. ACCOUNTING. OFFICE, OCC PREEMPTION RULES: OCC SHOULD FURTHER CLARIFY THE APPLICABILITY OF STATE CONSUMER PROTECTION LAWS TO NATIONAL BANKS 24 n.30 (2006), available at <http://www.gao.gov/new.items/d06387.pdf> (citing the OCC's statement that using an operating subsidiary has advantages in “transactions with affiliates, regulatory capital requirements, and accounting considerations.”)).

¹⁶⁵ *Id.*

¹⁶⁶ See Dietrich, *supra* note 113, at 199 (citing *The Office of the Comptroller of the Currency's Rules on National Bank Preemption and Visitorial Powers: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 108th Cong. 18-19 (2004)).

¹⁶⁷ See Burlingame, *supra* note 32, at 479 (citing Comptroller of Currency, *Economic Issues in Predatory Lending* (OCC Working Paper, 2003); (Roberto G.

approach may be the fact that the OCC is funded by national banks.¹⁶⁸ Therefore, it seems clear that the preemption of state law is another reason why federally-chartered banks would want to operate through a subsidiary instead of fully integrating the operation into their company.

VII. EFFECTS OF DESTROYING FEDERAL PREEMPTION

A bank's use of an operating subsidiary for mortgage lending offers competitive advantages. However, it also contributes to deregulation that many argue destroyed the subprime market. The OCC has considered a bank's use of an operating subsidiary structure as "a desirable way to meet rapid changes in the banking industry."¹⁶⁹ Alternatively, commentators assert that the main problem that caused the failure of the subprime mortgage market, looser lending standards and regulatory failure to curb such action, is fundamentally attributable to federal preemption.¹⁷⁰ Given that a bank's use of an operating subsidiary has resulted in federal preemption, operating subsidiaries can be viewed as a contributing factor to the failure of the subprime mortgage market.

Legislation reversing federal preemption seemingly pays more attention to fears over loose lending standards and a weak regulatory system than the competitive advantages that come with a bank's utilization

Quercia, Michael A. Stegman & Walter R. Davis, *Assessing the Impact of North Carolina's Predatory Lending Law*, 15 HOUSING POL'Y DEBATE 573, 578-79 (2004) (discussing the results of various studies that have examined the impact of North Carolina's Predatory Lending law on the availability of subprime credit.).

¹⁶⁸ See Dietrich, *supra* note 113, at 199 (citing *The Office of the Comptroller of the Currency's Rules on National Bank Preemption and Visitorial Powers: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 108th Cong. 18-19 (2004)).

¹⁶⁹ See Kim, *supra* note 41, at 295 (citing Investment Securities; Bank Activities and Operations; Leasing, 66 Fed. Reg. 34,784, 34,788 (July 2, 2001) (codified at 12 C.F.R. § 7.4006) ("For decades national banks have been authorized to use the operating subsidiary as a convenient and useful corporate form for conducting activities that the parent bank could conduct directly.")).

¹⁷⁰ *Id.* at 289 (citing Ben S. Bernanke, Chairman, Fed. Res. Speech at the Women in Housing and Finance and Exchequer Club Joint Luncheon: Financial Markets, the Economic Outlook, and Monetary Policy (Jan. 10, 2008), *available at* www.federalreserve.gov/newsevents/speech/bernanke20080110a.htm (expressing that the financial turmoil was complicated by a number of factors); U.S. DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 78 (2008), *available at* <http://www.treas.gov/press/releases/reports/Blueprint.pdf> (highlighting regulatory loopholes in the U.S. oversight system for the mortgage origination market)); *see also* Christopher Peterson, *supra* note 76, at 96-97 (arguing that preemption is consistent with a deregulatory agenda).

of an operating subsidiary.¹⁷¹ Such a consideration downplays the costs associated with national banks having to deal with “variant and disparate risks associated with disparate regulatory and economic conditions in each state.”¹⁷² In effect, then, proposed legislation reversing federal preemption for operating subsidiaries will force national banks to choose between circumventing liability and the costs of subjecting their lending operations to more onerous state regulation that varies significantly from state to state.

As an initial matter, making such a choice will require national banks to devote time and resources to such considerations. Practically, this will take resources away from traditional economies of scale considerations that contribute to their competitive position in the marketplace. State-chartered banks and banks of other countries will not have the same burden, and this could result in national banks competitive position being weakened by the practical effects of reversing federal preemption for operating subsidiaries.

Additionally, this consideration will affect a national bank's consideration of whether or not to acquire lending operations that are state-chartered. Because a national bank must now fully integrate a lending operation to avoid state regulation, the prohibitive cost of increased liability that would result from integration could render such an acquisition inefficient.

The decision a national bank will make as to whether or not to integrate a state-charted lending operation or to acquire a local lending operation will indicate the value banks place on considerations of liability and a soft regulatory environment. If national banks continue to operate their lending practices through an operating subsidiary that is now state regulated, this would indicate that banks value the decreased liability that comes with such an organization. However, if national banks choose to fully integrate, this will indicate that banks value lenient regulation more than decreased liability.

These value determinations will also provide clarity on the debates surrounding *Watters v. Wachovia Bank* and the dual banking system. If national banks favor a better regulatory environment over liability concerns, this may indicate that the benefits of a dual banking system outweigh the costs of increased liability. Alternatively, if national banks choose to submit their operating subsidiaries to state regulation, this may indicate that the

¹⁷¹ See generally Kim, *supra* note 41, at 323 (concluding “that the recent subprime mortgage turbulence may be a “necessary consequence” of the OCC's preemption since 2001, restructuring the OCC's regulatory scheme for operating subsidiaries can contribute to addressing problems in the subprime mortgage market.”).

¹⁷² Cole, *supra* note 66, at 259.

advantages of a dual banking system whereby regulators compete for customers to regulate does not outweigh the institutional costs of integration.

If the purpose of reversing federal preemption for operating subsidiaries of national banks is truly to increase consumer protection through increased regulation, this will only be furthered if the cost of integration is so high that national banks will submit to state regulation of their operating subsidiaries. Such a result would indicate that banks could efficiently operate with increased predatory lending laws, making the case that increased consumer protection laws are not so prohibitive on banks that they end up hurting consumers. Alternatively, if banks choose to integrate their operating subsidiaries in order to keep those operations federally regulated, this indicates that increased consumer protection laws are so harmful on banks that they would rather incur significant costs than submit to progressive state regulation. Such a result may indicate that increased consumer protection laws are so costly for banks that they will actually harm consumers.

The result of the choice banks must make, however, is likely to be driven by numerous considerations that will vary from bank to bank, making observing a significant trend in the predatory lending market unlikely. Nevertheless, any contribution that the reversal of federal preemption for operating subsidiaries of national banks will have to make this sharply divided debate over preemption and the dual banking system more clear will be beneficial.

VII. CONCLUSION

Creation of the Consumer Financial Protection Agency has implications that go well beyond the traditional debate over its passage. Ostensibly, the bill seems to be a compromise between Democrats wishing to create a new federal agency and Republicans who would like to limit the federal government's power over national banks. However, upon analysis of the environment that will ensue, it appears that Democrats will be able to have their cake and eat it too. As a result of this legislation, many nationally-chartered banks that operate their loan operations through a state-charted operating subsidiary will face a choice: submit to state regulation or increase liability.

They can either submit to regulation by progressive state law that focuses more on consumer protection than competition. If they choose this path, they will continue to have the advantage of limiting liability for the actions of their most risky operation, limiting reputational risk that results from litigation or foreclosures, and continuing to bypass federal regulations that govern the reallocation of capital they are allowed to pass between the institutions.

Or, they can attempt to continue to have such operations regulated by the federal government, whose major interest is currently the promotion of a competitive banking environment, by fully integrating subsidiaries into their parent institutions. Under this choice, they will lose all the benefits that come from the risk aversion that results from operating their most dangerous practice through a subsidiary, but they could continue to operate in an environment that gives a high priority to banking interests.

On the whole, age-old debates over the value of a dual-banking system and whether increased consumer protection laws actually benefit consumers are immensely involved in this proposed legislation. For those who believe that the failure of the subprime lending market was the result of deregulation and loose lending standards, destroying federal preemption for operating subsidiaries addresses that problem by subjecting those entities to more onerous state regulation. Alternatively, for those who think consumer protection only is furthered by making banks more competitive, destroying federal preemption for operating subsidiaries of national banks is a step in the wrong direction as there will be less of regulators competing for banks to regulate by offering the most competitive terms.

More important than the doctrinal approaches and the political divides of the debate over preemption and consumer protection is recognition of the fact that banks will face a choice that seemingly will make them choose the lesser of two evils. While the numerous variables that may factor into a bank's decision makes a large trend unlikely, any observable trend may provide some much needed clarity on this sharply divided debate over whether consumer protection laws benefit consumers. It seems clear then, that the proposed legislation destroying federal preemption for operating subsidiaries of national banks is properly placed within the same bill as legislation that would create a Consumer Financial Protection Agency.

